No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR ATTORNEYS' LIABILITY ASSURANCE SOCIETY, INC. AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether the Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), forecloses claims brought under a "scheme" liability theory pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §.78j(b), and SEC Rule 10b-5(a) & (c), 17 C.F.R. § 240.10b-5(a) & (c).

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INTEREST OF THE *AMICUS CURIAE*

Attorneys' Liability Assurance Society, Inc. ("ALAS") is the country's leading provider of professional liability insurance for large law firms.[1] Its membership includes 245 major law firms and 58,000 attorneys in 46 states and the District of Columbia—approximately one of every thirteen attorneys in private practice. ALAS member firms have

[1] Pursuant to Rule 37.6, no counsel for a party to this case authored any part of this brief, and no person or entity, other than the *amicus*, made a monetary contribution to the preparation or submission of this brief. All parties have consented to the filing of this *amicus curiae* brief, and their consent letters are on file with the Clerk of the Court.

advised virtually every significant public company in the United States. Among other services, ALAS provides its insured attorneys with extensive loss prevention advice, and it is widely credited as both the originator and leader of that discipline. Lawyers from ALAS's Loss Prevention staff were actively involved in the American Law Institute's development of the Restatement Third, The Law Governing Lawyers, and in the ABA Ethics 2000 Commission's revision of the Model Rules of Professional Conduct, completed in 2002, and they are involved in many other professional and bar association bodies that have defined the ethical and professional duties of lawyers. As part of its insuring duties, ALAS monitors the defense of professional liability claims asserted against its insured attorneys and law firms. By virtue of the many services it renders, ALAS has a unique understanding of the problems confronting law firms today. To this end, ALAS has filed numerous *amicus* briefs addressing issues of vital concern to the nation's legal community.

The question of "scheme" liability and its contours is of substantial importance to ALAS and the attorneys it insures and, derivatively, to the universe of public companies that look to ALAS lawyers for advice. If *Central Bank*'s clear rule were now eclipsed in fraud-on-the-market cases like this one by a multi-factor test that required consideration of the nature and degree of the involvement of lawyers and other secondary actors, then clever and unscrupulous plaintiffs would be able to craft their complaints to satisfy these tests. Trial courts must accept the well-pled facts as true, with the result that many complaints alleging financial statement fraud by public companies would survive threshold motions by secondary actors and launch them into hugely expensive fact discovery. Whether a lawyer actually gave the advice or performed the acts alleged in the complaint, or even knew of the client's fraud, cannot be raised until summary judgment at the earliest. These lawsuits invariably filed to force huge settlements, can be catastrophic for a law firm. Rather than

take the risk of being drawn into such catastrophic liability and damaging publicity, well-counseled law firms would avoid giving securities advice to troubled public companies – those clients that most need their help.

The social cost of this scenario would be unacceptably high, especially where the Securities & Exchange Commission ("SEC") has ample tools to deal with private law firms that shirk their professional duties. Put another way, a decision that gave the plaintiffs' securities bar a means of suing private law firms through artful pleading of a "scheme" to inflate a public corporation's financial statements would be unwise. It would be susceptible to abuse. It would disturb the equilibrium that now allows lawyers to advise troubled companies in need of legal counsel. And it would deter some lawyers from providing important professional services. ALAS has a strong interest in seeing that plaintiffs cannot, through artful pleading, reintroduce the uncertainty put to rest by *Central Bank*, thereby opening law firms and their insurers to billions of dollars in potential damages and settlement costs.

STATEMENT

Petitioner, Charter Communications, Inc. ("Charter"), a cable television provider, entered into contracts with two equipment vendors, Respondents Scientific-Atlanta, Inc. and Motorola, Inc., to provide set-top boxes that enable cable subscribers to receive programming. The contract provided that the boxes would be supplied for a fixed price. The complaint alleged, however, that Charter entered into transactions to artificially inflate its financial earnings by paying each respondent an additional $20.00 per set-top box, in return for their returning the additional payments to Charter in the form of advertising fees. The vendors, according to plaintiffs, knew that Charter was undertaking these transactions to inflate its financial picture.

While plaintiffs did not allege that the vendors had prepared or made any of the false or misleading financial statements issued to the investing public, they did assert that the vendors had participated in a scheme to defraud investors by artificially boosting the company's reported financial results and, accordingly, that the vendors were liable in damages under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (b) and implementing Rule 10b-5(a) & (c), 17 C.F.R. § 240.10b-5.

The district court, relying on this Court's decision in *Central Bank*, dismissed the complaint. Pet. App. 30a-71a. The court of appeals affirmed. *Id.* at 1a-11a. The Eighth Circuit relied primarily on the Court's ruling in *Central Bank* that Section 10(b) prohibits only "manipulative or deceptive" devices or contrivances and that the scope of Rule 10b-5 can be no greater than that of the underlying legislation. In rejecting Petitioner's attempt to invoke subsections (a) and (c) of Rule 10b, the court further observed that the scheme argument "depends on the assertion that *Central Bank's* analysis did not affect the scope of primary liability under subparts (a) and (c)," which the court found to be an unjustifiably narrow reading of *Central Bank*. Instead, the court found three governing principles in *Central Bank* and earlier decisions of the Court: that a private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b), including claims under Rule 10b-5(a) and (c); that a device or contrivance is not deceptive within the meaning of the statute absent a misstatement or failure to disclose by one who has a duty to disclose; and that the term manipulative in § 10(b) is a "term of art and refers to illegal trading practices such as wash sales, matched orders or rigged prices that are intended to mislead investors by artificially affecting market activity." Pet. App. 8a (internal quotations omitted). The court further concluded that a device or contrivance is not deceptive, within the meaning of § 10(b), "absent some misstatement or a failure to disclose by one

who has a duty to disclose;" and that to constitute manipulation with the meaning of Section 10(b), a secondary actor must "directly engage in manipulative trading practices." *Id.* at 8a-9a.

The court of appeals observed that "the focus of plaintiffs' § 10(b) and Rule 10b-5 claims was deception" by Charter in that plaintiffs had "alleged a 'continuous course of conduct' in which Charter allegedly 'made and/or failed to correct public representations that were or had become materially false and misleading regarding Charter's financial results and operations.'" *Id.* at 9a. Finding that the plaintiffs' allegations against the vendors under subparts (a) and (c) of Rule 10b-5 were an attempt to reinstitute aiding and abetting liability for Charter's false and misleading public statements under Section 10(b), and therefore were barred by *Central Bank*, the court affirmed the dismissal of the complaint. The court concluded that "any defendant who does not make or cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5." *Id.* at 9a. The court further ruled that adopting plaintiffs' position on scheme liability "would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress." *Id.* at 10a.

SUMMARY OF THE ARGUMENT

The policy issue that concerned the Court in *Central Bank* was that in the absence of clearly defined standards for liability under the anti-fraud statutes, professionals other than the securities issuer would be subject to abusive litigation. The Court emphasized that "the rules for determining aiding and abetting liability are unclear, in '*an area that demands certainty and predictability.*'" 511 U.S. at 188 (emphasis

added) (citation omitted). The Court, therefore, gave § 10(b) a clear and predictable reach. This certainty has allowed lawyers and law firms to provide securities disclosure advice to their clients with the assurance that doing so will not expose them to massive civil liability based on an artfully-drafted class action complaint wrongfully accusing the lawyers of participating in their client's fraud.

If the clear rule of *Central Bank* were replaced with an unpredictable multi-factor test that turns on allegations concerning the nature and degree of the involvement of lawyers and other secondary actors in a public company's alleged scheme to defraud investors, then the certainty provided by *Central Bank* would be lost. Lawyers and other professionals would be drawn into abusive litigation, for the more general the legal test, the easier it is to prepare a complaint that appears to meet the test and can survive a motion to dismiss. Trial judges who deny motions to dismiss are seldom willing to certify their rulings for interlocutory review under 28 U.S.C. § 1292(b), thereby propelling lawyers into crushingly expensive discovery. As the Court has recognized, plaintiffs with largely groundless claims should not be permitted to "take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value," *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955, 1966 (2007) (quotations omitted). This is, however, precisely what occurs in securities litigation. Vindication at the end of a long case is in theory possible, but in reality "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases before reaching those [trial] proceedings." *Id.* at 1967. The costs of defense and the potential for massive exposure in jury trials has led to an environment in which virtually all private securities cases that survive motions to dismiss are settled. And the settlements are dauntingly large.

The naming of securities lawyers as defendants could well become commonplace if scheme liability, with its vague and varying standards, were adopted by the Court. Securities lawyers regularly deal with complex issues and are often called upon to advise clients based on factual information that is incomplete or in flux. The assessment of a particular situation may also require the application of unsettled principles of law. Since disclosures are generally complex, it will often be possible, with hindsight, to allege that important information was omitted and that securities counsel was one of the background actors responsible. The role of the transactional lawyer providing services to large public companies such as the ones involved in securities class actions would be similarly subject to aggressive pleading under a scheme liability theory, since some action of counsel could always be labeled, with hindsight, as deceptive for purposes of withstanding a motion to dismiss. At the pleading stage, the law firm has no ability to explain these complex and fact-bound questions to the court.

The adoption of a scheme liability theory of secondary actor liability would likely also produce conflicts of interest generated by the tension between the attorney's duties to the client and preservation of the attorney-client privilege, on the one hand, and a scheme theory that, at least in some formulations, holds the attorney to the standard of "gatekeeper" and financial watchdog, on the other. Thus, scheme liability could as a practical matter punish the attorney for professionally responsible behavior.

At the same time, adoption of a scheme theory of secondary actor liability could chill well-counseled law firms from representing troubled public companies in securities-related work. An illustration of this phenomenon is the litigation aftermath of the savings and loan crisis of the 1980's when federal regulatory agencies embarked on a

campaign of lawsuits against directors of, and counsel for, many failed thrifts and banks. Recognizing that these suits were driven by a quest for their liability insurance, many commercial insurance carriers (although not *amicus*) introduced "regulatory" and other exclusions in their policies that foreclosed insurance coverage for claims arising out of failed banks and thrifts. The inclusion of a regulatory exception then caused many of the larger and well-advised law firms to avoid altogether representing troubled financial institutions and those that were in weakened financial positions—the group that one could argue most needed seasoned legal advice. Scheme liability, used as a tool to force settlements from attorneys and their insurers, could have a similar chilling effect on the willingness of attorneys to represent troubled public companies.

Therefore, if the court of appeals ruling were reversed, and the principles and reasoning of *Central Bank* abandoned, there would be widespread uncertainty concerning the reach of the securities laws with substantial detrimental consequences for securities attorneys and the companies they advise. In light of the SEC's unquestioned authority to pursue claims against outside counsel for aiding and abetting client misconduct, and its Sarbanes-Oxley authority to discipline attorneys appearing and practicing before it, there is no need to extend the implied right of action of § 10(b) to scheme liability, as Petitioner requests.

ARGUMENT

I. THE SCHEME LIABILITY THEORY WOULD REINSTATE THE VERY UNCERTAINTY THAT *CENTRAL BANK* SOUGHT TO ELIMINATE AND WOULD EXPOSE ATTORNEYS TO RUINOUS CIVIL LIABILITY AT CONSIDERABLE AND UNWARRANTED SOCIAL COST.

This Court is familiar with the nature of class action securities lawsuits, their potential for abuse and the detrimental and sometimes catastrophic effects such lawsuits have had on defendants. Lawyers and law firms have not been sued as often as other professionals in securities class actions involving exchange-traded securities since *Central Bank*. Yet there is no question that the scheme liability theory advanced by Petitioner would, if adopted as a basis for secondary actor liability in fraud-on-the-market cases like this one, permit clever plaintiffs to sweep attorneys into the morass of these lawsuits. Often enough, the attorneys will have been doing no more than carrying out their traditional roles as client advisors. Nonetheless, attorneys would be sued, damaged in the public eye, and would become targets for high priced settlements.

A. The securities class action is widely seen as uniquely susceptible to abuse. As the Court recently observed, securities litigation presents "a special risk of vexatious litigation" and is a "particularly troublesome subset of class actions." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 86 (2006) (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)). One commentator recently referred to the securities class action lawsuit as "the 800-pound gorilla that dominates and overshadows other forms of class actions." John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1539 (2006). In

these actions, "the settlement payments and the litigation expenses of both sides fall largely on the defendant. . . ." *Id.* at 1536. Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. 104-67, 109 Stat. 737 (Dec. 22, 1995), to remedy "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and 'manipulation by class action lawyers of the clients whom they purportedly represent.'" *Dabit*, 547 U.S. at 81 (*citing* H. R. Rep. No. 104-369 at 31 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730).[2] Despite PSLRA safeguards such as a heightened pleading standard, securities class action complaints often survive threshold motions since at the motion to dismiss stage trial courts must accept the factual allegations as true. Denials of threshold motions launch the parties into hugely expensive fact discovery.

Trial judges who deny motions to dismiss are seldom willing to permit interlocutory review under 28 U.S.C. § 1292(b). Thus, while plaintiffs with groundless or marginal claims should not be permitted to "take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value," *Bell Atlantic Corporation v. Twombly*, 127 S. Ct. 1955, 1966 (2007) (quotations omitted), this is exactly what occurs in securities litigation. The fear of litigating class actions is

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[2] Congress, when enacting the PSLRA, observed that the act was prompted by "the routine filing of lawsuits against issuers of securities . . . whenever there is a significant change in the issuer's stock price, without regard to any underlying culpability of the issuer, and with only a faint hope that the discovery process might lead eventually to some plausible cause of action." H.R. Rep. 104-369 at 31. The legislative history noted that "[a] complaint alleging violations of the Federal securities laws is easy to craft and can be filed with little or no due diligence," S. Rep. No. 104-98, at 8 (1995), while "[t]he dynamics of private securities litigation create powerful incentives to settle, causing securities class actions to have a much higher settlement rate than other types of class actions," *id.* at 6.

magnified by the specter of joint and several liability, a liability out of proportion to the alleged wrong.

This common scenario presents defendants with the choice of settling at great expense or litigating for years—and then possibly facing a jury with billions of dollars at stake. And, almost invariably, "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases before reaching those [trial] proceedings," *Twombly* at 1967, for defendants typically cannot "stake their companies on the outcome of a single jury trial." *In re Rhone-Poulenc Rorer, Inc.*, 51 F.3d 1293, 1299 (7th Cir. 1995). These so-called "blackmail settlements" induced "by a small probability of an immense judgment" have long been recognized as a significant problem with the class action device. *See* Henry J. Friendly, *Federal Jurisdiction: A General View* 120 (1973); Fed. R. Civ. P. 23(f), 1998 advisory committee notes (1998 amends.) ("An order granting certification . . . may force a defendant to settle rather than incur the costs of defending a class action and run the risk of potentially ruinous liability."). In sum, it is common knowledge that "[p]rivate securities fraud actions . . . can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007).

Not surprisingly, therefore, in private securities fraud class litigation, "virtually all cases are settled." Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 578 (1991). Indeed, according to one report, "no case has been tried since the PSLRA went into effect; all have either been settled or dismissed." *See* Richard Painter et al., *Private Securities Litigation Reform Act: A Post-Enron Analysis* 7 (Federalist

Soc'y for Law & Pub. Policy Studies 2002).[3] Even a claim that is later dismissed may inflict serious reputational damage, cost huge amounts to defend, and produce a sizeable settlement. *See* Jonathan Weil, *Win Lawsuit—and Pay $300 Million*, Wall St. J., Aug. 2, 2004, at C3. Since the merits of the law underlying these securities class action lawsuits are seldom, if ever, tested by an appeal to a federal court of appeals, plaintiffs have a huge incentive to bring these lawsuits, without much regard to the merits of their claims.[4]

The settlements, moreover, are often dauntingly large, and for the last several years they have been rising. As Cornerstone Research's recently issued 2006 Review and Analysis reports, "[l]ike 2005, 2006 proved to be another record-breaking year for securities case settlements." Laura E. Simmons, Ellen M. Ryan, Cornerstone Research, *Securities Class Action Settlements: 2006 Review and Analysis*, at 1 (2007). Even excluding the $6.6 billion partial settlement in Enron, "the total value of cases settled during the year exceeded all previous years, reaching an unprecedented $10.6 billion. In addition, while median settlement amounts changed little, average settlement amounts in 2006 increased

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[3] *See* Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2064 (1995); Woodruff-Sawyer & Co., *A Study of Shareholder Class Action Litigation* 25 (2002). As the Second Circuit remarked in *Goldberger v. Integrated Resources Inc.*, 209 F.3d 43, 52 (2d Cir. 2000), "[Melvyn I.] Weiss and his partner William S. Lerach of the Milberg firm have stated that losses in these cases are 'few and far between,' and that they achieve a 'significant settlement although not always a big legal fee, in 90% of the cases [they] file.'" (*quoting In re Quantum Health Res. Inc. Sec. Litig.*, 962 F. Supp. 1254, 1258 (C.D. Cal. 1997)).

[4] While the absolute number of private securities fraud suits appears to have peaked for now as a result of a sustained rise in the stock market, they will undoubtedly explode again with any significant market correction or fall.

almost five-fold to reach their highest levels to date." *Id.* The recently issued Bloomberg-Schumer Report, authored by McKinsey & Co. and the New York City Economic Development Corporation, confirms that "[t]he total bill for securities settlements in 2005 was $3.5 billion (omitting WorldCom-related settlements of approximately $6.2 billion), up more than 15 percent over 2004, and nearly 70 percent over 2003."[5]

B. It is self-evident that scheme liability, with its indefinite standards, would fuel securities litigation. The more broadly a legal test is framed, the easier it is for an artful pleader to draft a complaint likely to withstand a motion to dismiss. In fact, the policy issue that deeply concerned the Court in *Central Bank*, and shaped its ruling, was that in the absence of clearly defined standards for liability under the antifraud statutes, attorneys and other securities professionals would be subject to abusive litigation. The Court stated that "the rules for determining aiding and abetting liability are unclear, in '*an area that demands certainty and predictability.*'" 511 U.S. at 188 (emphasis added) (citation omitted). Obviously, in a situation where "settlements in large [securities] class actions can be divorced from the parties' underlying legal positions," *Hevesi v. Citigroup Inc.*, 366 F.3d 70, 80 (2d Cir. 2004), having "bright-line" rules to guide conduct and define legal rights and liabilities is essential.

Notwithstanding the need for certainty and predictability, the scheme liability decisions that have been crafted by the lower courts to date base liability on imprecise rules with predictably inconsistent results. *See Simpson v. AOL Time Warner*, 452 F.3d 1040, 1048 (9th Cir. 2006) (defendant "must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance

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[5] *See Sustaining New York's and the US's Global Financial Services Leadership*, (Jan. 2007) at 73-74.

of the scheme;" allegations that third party vendors entered into sham round-trip and barter transactions as part of scheme to inflate public company's reported revenues held insufficient to state § 10(b) claim against vendors); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 502-04 (S.D.N.Y. 2005) (defendant must have "directly or indirectly used or employed any device or contrivance with the capacity or tendency to deceive;" banks held subject to scheme liability for securitizing and factoring allegedly worthless receivables to inflate public company's reported cash flow but not for allegedly making high-interest loans disguised as equity investments or assets in order to allow company to misreport its debt level); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336 (S.D.N.Y. 2004) (accountants subject to "scheme" liability for their "central role" as "chief architect" of misleading accounting and transactions used to inflate client's revenues); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003) (defendant must have "substantially participated in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device . . . intended to mislead investors;" defendants held subject to scheme liability for allegedly setting up and operating shell software companies to provide licensing revenue to inflate public company's bottom line). As the district court in *In re Lernout & Hauspie Sec. Litig.* admitted, "the line between primary and secondary liability in a scheme or course of business case can be murky and fact-sensitive." *Id.*

In *Simpson v. AOL Time Warner*, the Ninth Circuit rejected the position of the SEC, similar to that urged by Petitioner here, that a defendant qualifies as a primary violator when he or she engages "in a transaction whose principal purpose and effect is to create a false appearance of revenues." 452 F.3d at 1048. Recently, SEC Commissioner Atkins observed in testimony before the House Financial Services Committee that "based on experience," the position put forward by his agency with respect to scheme liability was wrong. Speaking

of a proposed *amicus curiae* brief in this case, which the Solicitor General of the United States did not authorize,[6] Commissioner Atkins stated that "I dissented from our brief because based on experience, you know . . . I didn't think our test worked. And that's through experience at the SEC and then also seeing what the various circuits came up with." *See A Review of Investor Protection and Market Oversight With the Five Commissioners of the Securities and Exchange Commission*, Hearings Before the House Financial Services Committee, 110th Cong., 1st Sess. (June 26, 2007) (official pagination not yet available).[7] Commissioner Casey agreed with this assessment, stating that "the brief before us was overly vague and broad in terms of the sweep of conduct that would be included, potentially including conduct that would normally be charged as aiding and abetting liability." *Id.* SEC Chairman Cox, in testimony during the same hearing,

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[6] The SEC voted 3-2 to file a brief as *amicus curiae*, in support of Petitioner in this case. The Solicitor General declined to authorize the brief, allegedly after communication with the White House. While the Solicitor General is almost always the final decision-maker with respect to these matters, Presidents (including Truman, Eisenhower, and Clinton) and Attorneys-General have on occasion intervened in these decisions. *See* Drew S. Days III, *When the President Says "NO": A Few Thoughts On Executive Power and The Tradition of Solicitor General Independence*, 3 J. Appellate Prac. and Process 509, 519 (2001) (concluding that the President "is ultimately responsible, in both legal and political terms, for the positions his administration takes in court."). In any event, the views of the SEC would not be entitled to deference in a case where a judge-made implied right of action is at issue, the question turns on the reach of the statute, and the Court previously rejected the SEC's arguments in *Central Bank*, the very case being revisited. *See Dirks v. SEC*, 463 U.S. 646, 656 (1983) (rejecting the SEC's position because it "differs little from the view we rejected as inconsistent with congressional intent" in an earlier case).

[7] The hearing proceedings have not yet been published. They are available, however, from Lexis/Nexis, Federal News Service, Inc.

stated that scheme liability must be understood as only applying to "a primary actor, a principal violator." *Id.*

The standards of liability announced by the lower court rulings, and suggested by the SEC as an *amicus curiae* in litigation, have one thing in common: because of their imprecision they would increase the already intense pressure on defendants to settle class action lawsuits without regard to the lawsuit's merits because these tests for scheme liability provide no clear and predictive rules, notwithstanding that this is "an area that demands certainty and predictability." *Central Bank*, 511 U.S. at 188.

C. Not only would scheme liability fuel securities litigation, but plaintiffs' success at the motion to dismiss stage would be significantly enhanced because the scheme liability theory virtually reads out of the legal equation the reasonable reliance element that this Court in *Central Bank* found to be so important. The Court in *Central Bank* explained that permitting aiding and abetting liability under § 10(b) would allow plaintiffs to "circumvent the reliance requirement," since a defendant "could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions." 511 U.S. at 180. Reasonable reliance serves to establish the causal connection between a defendant's misrepresentation (or other "action") and a plaintiff's injury that is required for plaintiff to recover damages.

Despite the paramount importance of demonstrating reasonable reliance in a case brought pursuant to § 10(b), the facts of this case illustrate how dangerously open-ended Petitioner's theory is and how the reliance requirement, an important safeguard, would be all but eliminated by the liability theory urged by Petitioner. Even though the "focus" of Petitioner's § 10(b) claim was that investors had been deceived by Charter's false and misleading public statements, the district court, in dismissing the complaint, observed that plaintiffs "do not assert that Scientific-Atlanta and Motorola

made any statement, omission or action at issue or that plaintiffs relied on any statement, omission or action made by either of them;" that plaintiffs "do not allege that Scientific-Atlanta or Motorola were responsible for, or were involved with, the preparation of Charter's allegedly false or misleading financial statements," its "improper internal accounting practices," or the "false or misleading financial statements" made by Charter and its former executives; that "[p]laintiffs also do not allege that any of the allegedly misleading statements listed in the amended complaint were made, seen, or reviewed by Scientific-Atlanta and Motorola," and that plaintiffs "have not alleged that Scientific-Atlanta or Motorola had any duty to Charter's investors." Pet. App. 41a. Respondents explained in their appellate briefs that they had accounted for the transactions properly and lawfully in their own financial statements, had expected Charter to do the same, and did nothing to hide the transactions. (Br. of Scientific-Atlanta, Inc. at 3).

If the Court were to find scheme liability appropriate on these facts, then anyone who did business with, or supplied information to, a public company, whether or not an investor relied upon or even knew about the transaction or the information, could be drawn into securities litigation.[8] In these circumstances, the attorney, and his or her insurer, would be easy targets.

Securities lawyers regularly deal with complex issues and are often called upon to assess and advise clients based on factual information that is incomplete or in flux—facts that are not subject to an unequivocal analysis. The assessment of a particular situation, moreover, may call for the application

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[8] Petitioner leaves reliance for the very end of its brief and makes no cogent arguments in support of this key element of a 10(b) cause of action. Indeed, Petitioner admits that "Respondents did not themselves disseminate the false information to the securities market." Pet. Br. at 38.

of unsettled principles of law. Since disclosures are often complex, it will always be possible, with hindsight, to allege that important information was omitted and that securities counsel was one of the background actors responsible. *See* Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons*? 48 Vill. L. Rev. 1097, 1128 (2003) ("[t]he quality of the attorney's counsel is a function of the quality of information he receives from the client."). The role of the transactional lawyer providing services to large public companies such as the ones involved in securities class actions would be similarly subject to aggressive pleading under a scheme liability theory, since some action of counsel could always with hindsight be labeled as deceptive for purposes of withstanding a motion to dismiss.

The impact that such amorphous standards can have on a law firm is well-illustrated by the securities litigation arising out of the collapse of Enron. The district court in January 2002 ruled that, accepting the facts pled as true, the plaintiff class had stated a claim under Rule 10b-5 against several secondary actors, including the law firm of Vinson & Elkins LLP ("V&E"). The court adopted a "creator" theory of liability of secondary actors for false statements made by issuers. Under this theory, which had been proposed by the SEC, a person can be a primary violator if he or she authors misrepresentations (or perhaps allows material facts to be omitted) in a document to be given investors, even if the idea for those misrepresentations came from someone else. *In re Enron Corp. Sec. Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 704 (S.D. Tex. 2002). The court accepted as true the allegations lodged against V&E that it was "not merely a drafter but essentially a co-author" of Enron's public disclosures, and it denied the firm's motion to dismiss. As a bankruptcy examiner later observed in an exhaustive report, and V&E demonstrated in its motion for summary judgment, V&E's role in the disclosures was actually limited and episodic, and the law firm had no control over Enron's

ultimate disclosures. *In re Enron Corp., et al.*, No. 01-16034 (AJG), United States Bankruptcy Court, Southern District of New York, *Final Report of Neal Batson, Court Appointed Examiner, Appendix C, Role of Enron's Attorneys*, at 84, 87. Yet it was not until 2007, after suffering years of extraordinarily expensive and disruptive discovery, and with no ruling on its motion for summary judgment, that the law firm was eventually dismissed voluntarily as a party. Financial and reputational harm to the law firm had already occurred.

D. Prior to *Central Bank*, most decisions involving allegations against law firms concerned aiding and abetting liability. While as a general matter the courts' decisions in the aiding and abetting cases tended to construe a lawyer's duties narrowly,[9] the cases failed to offer consistent guidance.[10] The very same amorphous terms now used to characterize scheme liability, including "participation" and "substantial assistance," were applied by the courts.

This Court in *Central Bank* determined that the various tests then utilized by courts to determine secondary liability lacked clarity and produced decisions "made on an ad hoc basis, offering little predictive value." 511 U.S. at 188-89

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[9] *See* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyer's Responsibility for Clients' Fraud*, 46 Vand. L. Rev. 75, 84-94 (1993) (observing that prior to *Central Bank*, the case law narrowly construed a lawyer's duties in aiding and abetting cases).

[10] *Compare Schatz v. Rosenberg*, 943 F.2d 485, 497 (4th Cir. 1991) (lawyers had no fiduciary duties to disclose client's misrepresentation where they "did no more than 'paper the deal' or act as a scrivener"), *cert. denied*, 503 U.S. 936 (1992) and *Abell v. Potomac Insurance Co.*, 858 F.2d 1104, 1124 (5th Cir. 1988) ("In general, the law recognizes such suits only if the non-client plaintiff can prove that the attorney prepared specific legal documents that represent explicitly the legal opinion of the attorney preparing them, for the benefit of the plaintiff."), *vacated on other grounds, Fryar v. Abell*, 492 U.S. 914 (1989), *with SEC v. Forma*, 117 F.R.D. 516, 526 (S.D.N.Y. 1987) (attorney's "silence consciously intended to facilitate a fraud can create secondary liability").

(quotation omitted). Moreover, "because of the uncertainty of the governing rules, entities subject to secondary liability as aiders and abettors may find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." *Id.* at 189. The Court went on to give § 10(b) a clear and predictable reach and, on the basis of the statute, found no provision for aiding and abetting liability. This certainty has permitted lawyers and law firms to provide securities disclosure advice and do transactional legal work for their clients with the assurance that doing so will not expose them to massive civil liability based on an artfully-drafted class action complaint wrongfully accusing the lawyers of participating in their clients' fraud.

Scheme liability for secondary actors in securities fraud cases would return the state of the law to its pre-*Central Bank* days, making attorneys and other secondary actors vulnerable to a securities lawsuit where the primary purpose of the litigation is not vindication on the merits, but achieving a windfall settlement.

II. IMPOSITION OF SCHEME LIABILITY COULD AS A PRACTICAL MATTER PUNISH THE ATTORNEY FOR PROFESSIONALLY RESPONSIBLE BEHAVIOR AND CREATE POTENTIAL CONFLICTS OF INTEREST.

Recent corporate disasters, such as Enron and WorldCom, have turned attention to lawyers and other third party professionals, who are often referred to as "gatekeepers." Ignoring the differing roles and responsibilities of the different professions, some commentators have posited that these gatekeepers should all be viewed as having duties to the investing public. However, as this Court has noted, in contrast to the accountant, who "[b]y certifying the public reports that collectively depict a corporation's financial status

. . . assumes a *public* responsibility transcending any employment relationship with the client," the lawyer's role is that of "the client's confidential adviser and advocate." *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

Lawyers generally have no duty to disclose information to non-clients. A lawyer advising a client, including a public company, owes his or her duties of loyalty solely to that client. Model Rules of Prof'l Conduct R. 1.13(a). That duty is to render advice consistent with the interests of the client. Further, under Rule 1.2(a), ABA Model Rules of Professional Conduct, the lawyer is obligated to respect the client's decision-making authority—authority which in a public company rests with management and the board of directors. The lawyer, therefore, generally owes no primary duties under Rule 10b-5 to investors. *Schatz v. Rosenberg*, 943 F.2d 485, 491 (4th Cir. 1991), *cert. denied*, 503 U.S. 936 (1992) ("[A]bsent a fiduciary or other confidential relationship, lawyers have no duty to disclose information about clients to third party investors."). Accordingly, unless the attorney speaks with the intention that a third party investor will rely on his or her statements, representation of clients is shielded by a lawyer's duty to zealously represent his client.

The attorney, in addition, is bound by the attorney-client privilege, the oldest privilege recognized at common law. As the Court observed in *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1991), the purpose of the privilege

> is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client.

The Court noted that this policy concern is very strong when a corporation is the client, "[i]n light of the vast and complicated array of regulatory legislation confronting the modern corporation." *Id.* at 392. And the Court held that the rules governing the attorney-client privilege should be broadly construed to encourage corporations to comply with the applicable law. *Id.*

The attorney-client privilege, in order to promote a full and frank exchange of information between the client and the attorney and thereby permit the most effective legal representation, generally bars disclosure of protected information to the public. This does not mean, of course, that the attorney can ignore the interests of the investing public when advising clients. The attorney must be aware of the client's duties to the public and the consequences to the client of a violation of such duties. Absent direct affirmative misconduct, for example when an attorney lies to an investor intending that the investor rely on the lie or files with the SEC client statements that the attorney knows to be false, attorneys should be deemed as having duties to their public corporate clients only with an obligation to preserve client confidences. Attorneys, accordingly, differ from other so-called gatekeepers like accountants, who do have traditional and recognized duties directly to the public.

If attorneys could be targeted under scheme liability theories for their clients' fraudulent securities disclosures, conflicts of interest would inevitably arise, generated by the tension between duties to the client and preservation of the attorney-client privilege, on the one hand, and a theory that, at least in some formulations, holds the attorney to the standard of "gatekeeper" and financial watchdog, on the other. Yet there is clearly no need for the Court to create new liabilities and ethical quandaries for practicing lawyers, since the question concerning when attorneys should be held responsible in private litigation for client fraud is resolved by

the Court's legal analysis in *Central Bank*. The Court in *Central Bank* rejected the legal underpinnings of the scheme liability theory as applied to false statements made by others, determining that § 10(b) simply does not support such a cause of action. Congress, moreover, has twice rejected the private right of action for aiding and abetting liability that Petitioner in effect seeks from the Court in the form of a scheme theory that would impose liability on secondary actors for fraudulent statements made by others. In 1995, Congress enacted the PSLRA, a statute that introduced a number of substantive and procedural reforms designed to curb abuses in security class action lawsuits. Notably, the Act restored the authority of the SEC to proceed against those who aid and abet securities fraud. Congress, however, declined to provide a private right of action against aiders and abettors of securities fraud. In 2002, Congress revisited the issue in the Sarbanes-Oxley Act. Once again, despite pressure to amend the 1934 Act to subject aiders and abettors to private lawsuits, Congress declined to do so. When congressional decisions to retain the status quo are made after active deliberation, this Court affords those decisions significance. *See, e.g., Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 378 n.13 (2000) ("The fact that Congress repeatedly considered and rejected targeting a broader range of conduct lends additional support to our view.").

Additionally, the SEC has ample authority to bring actions against attorneys for wrongdoing in their representation of public companies. First, the SEC may pursue an attorney by an action in federal district court seeking injunctive and other relief for aiding and abetting. *See, e.g., SEC v. Fehn*, 97 F.3d 1276 (9th Cir. 1996), *cert. denied*, 522 U.S. 813 (1997) (attorney violated Rule 10b-5 as aider and abettor when he reviewed and filed client's disclosure statements, knowing of material omissions). The SEC can also bring administrative cease-and-desist proceedings against attorneys who violate or are about to violate the securities laws. *See* Securities

Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990). Finally, the SEC, pursuant to Rule 102(e) of its Rules of Practice, 17 C.F.R. § 201.102(e) (2007), may deny an attorney, either temporarily or permanently, the right to appear and practice before the agency. Courts have recognized that a securities suit brought by the SEC has greater legitimacy than suits brought by private parties because the SEC "is a responsible governmental agency." *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 33 n.3 (D.C. Cir. 1987).

Notably, the Sarbanes-Oxley Act instructed the SEC to promulgate rules setting minimum standards for the attorneys who practice before the agency. *See* 15 U.S.C. § 7245 (Supp. II 2004). The SEC has issued regulations requiring attorneys, in prescribed circumstances, to "report up" the corporate hierarchy when there is evidence of wrongdoing by the officers, employees or agents of the company. A lawyer is now required to report to the client evidence that a material breach of the securities laws or a violation of fiduciary duties is "reasonably likely." 17 C.F.R. § 205.2(e) (2007). The triggering evidence is defined as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." *Id.* The rules, however, specifically recognize that an attorney owes his or her professional and ethical obligations to the corporate client, 17 C.F.R. § 205.3(a), and the rules do not create a private right of action against an attorney.[11] 17 C.F.R.

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[11] Further, under Rule 1.2, comment 10, ABA Model Rules of Professional Conduct, a lawyer may not "continue assisting a client in conduct that the lawyer originally supposed was legally proper but then discovers is criminal or fraudulent." However, absent a red flag of some kind, an attorney has no duty of inquiry. ABA Committees have stated that a lawyer is not obligated to "carry on an investigation by searching out or developing facts and information beyond such as are already

§ 205.7. The reporting up duty, unlike Petitioner's scheme liability theory, is fully consistent with the attorney's duties of confidentiality and client loyalty.

III. SCHEME LIABILITY COULD ENCOURAGE ATTORNEYS TO DECLINE THEIR TRADITIONAL ROLES AS CLIENT ADVISORS.

Subjecting attorneys to "scheme" liability as "substantial participants" in misleading statements and/or omissions in an issuer's public filings, press releases and shareholder reports, even with no indication on the face of the documents of the lawyer's involvement, would have profoundly negative implications. One is that if attorneys could be targeted for little more than a failure to prevent client misconduct, or to fully disclose such misconduct to the public, a result that would follow from many of the court-crafted scheme liability tests, then well-counseled lawyers would decline to provide disclosure advice to troubled clients—precisely those who need it most—because of potential civil liability.

Moreover, opening the door to liability on a scheme theory, where even a lawyer's drafting suggestions might involve him in a lawsuit as a defendant, would send a clear signal to securities lawyers across the country that it is better to do nothing than to counsel a public company on difficult disclosures. As the SEC stated in *In re Carter*, No. 3-5464, 1981 WL 384414 (SEC Feb. 28, 1981), "[c]oncern about his own liability may alter the balance of [a lawyer's] judgment in one direction as surely as an unseemly obeisance to the wishes of his client can do so in the other. While one imbalance results in disclosure rather than concealment, neither

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available to him from the assigned legal work in which he is engaged." ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Request for Information, Second Report of the Committee on Audit Inquiry Responses Regarding Initial Implementation, 32 Bus. Law. 177, 180 (1976).

is, in the end, truly in the public interest." *Id.* at *25. A standard "which would permit a lawyer to avoid or reduce his liability simply by avoiding participation in the drafting process, may well have the undesirable effect of reducing the quality of the disclosure by the many to protect against the defalcations of the few." *Id.* at *24. Similar considerations apply to the legal work performed by transactional lawyers who are not even involved in advising on the clients' public financial disclosures.

This Court has recognized that "newer and smaller companies" often have difficulty obtaining high-caliber professional counsel because their "business failure would generate securities litigation against the professional." *Central Bank*, 511 U.S. at 189. Adoption of a scheme theory of secondary actor liability, because it would work an extraordinary expansion in the reach of implied private actions, could chill law firms from representing such companies as well as companies experiencing financial difficulties.

A vivid illustration of this phenomenon is the litigation aftermath of the savings and loan crisis of the 1980s. Although there was widespread evidence that macroeconomic trends, abnormal interest rate movements, and regulatory constraints were the driving factors in the collapse of the thrift industry, *see United States v. Winstar Corp.*, 518 U.S. 839, 845-48 (1996), the federal deposit insurance agencies and thrift regulators embarked on a campaign of lawsuits against directors of, and counsel for, many failed thrifts and banks. Recognizing that these suits were driven by a quest for their liability insurance, many commercial insurance carriers (although not ALAS) introduced "regulatory" and other exclusions in their policies that foreclosed insurance coverage for claims arising out of failed banks and thrifts. The federal courts of appeals rejected the argument that the regulatory exception violated public policy. *See Am. Cas. Co. v. FDIC*, 39 F.3d 633, 638-39 (6th Cir. 1994); *FDIC v. Am. Cas. Co. of*

Reading, Pa., Inc., 995 F.2d 471, 473 (4th Cir. 1993); *St. Paul Fire & Marine Ins. Co. v. FDIC*, 968 F.2d 695, 702 (8th Cir. 1992); *see generally*, John K. Villa, *Bank Directors', Officers', and Lawyers' Civil Liabilities*, § 4.09[B], at 4-49 (Supp. 1996) (discussing the exception and collecting cases). The inclusion of a regulatory exception caused many of the larger and well-advised law firms to avoid altogether representing troubled financial institutions and those that were in weakened financial condition—the group that one could argue most needed sound legal advice.[12] Whether or not one could defend the judgment of the deposit insurance officials in their litigation campaign against law firms that represented failed banks and thrifts, few believe that the plaintiffs' securities bar should be handed a comparable litigation weapon, *i.e.* scheme liability, that would achieve a similar result.

In sum, as a matter of both law and policy, the judgment of the Eighth Circuit should be affirmed. If that ruling were reversed and *Central Bank* abandoned, there would be widespread uncertainty about the reach of the securities laws, with significant detrimental consequences for attorneys and the companies they advise.

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[12] Ironically, the federal deposit insurance agencies turned to their pursuit of law firms only after their claims against thrift and bank directors had resulted in "regulatory exclusions" being introduced into most directors and officers liability insurance policies and "outside" directors had largely disappeared from the board rooms of troubled thrifts.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be affirmed.

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